Remarks of

Deputy Under Secretary of Defense (Industrial Policy)

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Introduction

I can now see that we have violated General Martin's principle of "big to small" by asking me to precede Secretary Roche! But I am delighted to be here this morning, particularly because I have learned during the course of my tenure that Secretary Roche has strong views about my purview, the defense industrial base. So by preceding him, I have a prayer of a chance of setting the stage a bit!

I would like to set this stage by spending a bit of time talking about our vision for the 21st century defense industrial base: how must it be able to function, what are its critical capabilities, and optimal structure. I will then close in speaking about a series of defense industrial base studies we embarked on in February of this year to make sure that the defense industrial base expands, transforms, and continues to deliver critical military capabilities to the war fighter well into the 21st century.

The Defense Industrial Base: What are the Critical Characteristics of its Culture?

It is our view that in the next ten years, the defense industrial base will change in ways important for 21st century warfare. First, World War II-era capacity, stockpiling, and surge paradigms will be less important going forward. It must be remembered that at the time of the onset of World War II, much of our current defense industrial base didn't yet exist. Even our oldest companies were "barely out of high school,"--Boeing, Lockheed, and Raytheon having been established in the decade between 1915 and 1925.

In the conflicts spanning from Korea to Operation Iraqi Freedom, many lessons were learned about operational and technical deficiencies, as well as about the difficulty of combating asymmetrical war fighting tactics. Notably, none of these conflicts required the widespread surge and stockpiling of the defense industrial base as had been the case in World War II. That said, for Operation Enduring and Iraqi freedom my office quietly processed more than two dozen changes in industrial priorities to bring needed equipment to the war fighter on an urgent basis: items ranging from Multispectral Targeting Arrays for UAVS to the Spectra Shield plates for anti-ballistic vests which every American soldier in Iraq will have by the end of the year.

And of course, by now, all of you know the exploits of our precision guided munitions manufacturers who more than doubled laser guided bomb production at a one-third unit price reduction and tripled production of JDAMs—all over the course of less than a year! It really was the flexibility of our production lines and adaptability of our technology which were the critical characteristics of our defense industrial base in these most recent engagements—very different than the World War II examples. But I must also pay tribute to distinction that our corporate culture had then and has now: the war fighter is their most important constituent.

And I would be remiss if I didn't take this opportunity to pay tribute as well to the importance of the global defense industrial base to our ability to fight and succeed. During Operation Iraqi Freedom, the French firm Deschamps delivered critical landing mats to Kuwait in support of our troops. The mats reduced dust and provided a visual reference for land, thus reducing helicopter hard landings. Our pilots called the mats "phenomenal." EADS's Manching facility was able to produce repair parts for a

damaged F-18 in five days—working in advance of receiving a formal contract. It would have taken an American company two months to complete the repair and return the F-18 to combat.

The JSLIST suit used in Operation Iraqi Freedom which provides our troops protection from chemical contamination is also a product of the global industrial base: a proprietary German design produced by a Japanese company capable of meeting—and exceeding—program requirements.

Finally, we all know the important role of Rolls Royce's lift fan engine technology in the Joint Strike Fighter. But the international supplier base of the partnership countries in the Joint Strike Fighter program is also teaching us a thing or two about the smaller members of the global defense industrial base. One Canadian company which develops decision support software for JSF will be sourcing the equivalent of its entire company's current revenues from the JSF program alone later this decade.

What is the Optimal Structure of the Defense Industrial Base

This is the kind of vibrancy and flexibility that we laud among defense suppliers and that is such an important part of what the global defense industrial base does for the war fighter. And in spite of what some may consider excessive consolidation in the defense industrial base, it is this vibrancy in emerging defense suppliers that makes us so confident that the composition of the defense industrial base will change by growing in the next decade.

But first to the consolidation numbers. Since 1994, the Department has reviewed over 230 mergers or acquisitions of U.S. defense companies. In this Administration, nearly 90 such transactions have been reviewed with a value over nearly $80 billion. Interestingly, 2003 was a year marked by a statistically higher number of transactions—37 so far against a ten-year annual average of 23. But the value of the transactions reviewed in 2003 totals about $8 billion—less than an eighth of the value of the 28 transactions in 2001.

We continue to be committed to a timely and systematic review process in order to remove uncertainty among the parties and save them—and us—time and money. We are

also intent on achieving an appropriate balance between providing smaller, emerging defense suppliers exit strategies with which they can monetize their investments; our commitment to market forces; and to maintaining a competitive structure of the overall defense industrial base aligned to 21st century war fighting requirements. Only one transaction was denied, one required a consent decree, and one a letter of agreement. In both of the latter cases, the intent was to provide on a merchant vendor basis to the overall defense industrial base particularly critical components or know-how.

With regard to foreign acquisitions of U.S. defense companies, there appears to be a misperception that this Administration has closed the door to transnational consolidation. Nothing could be further from the truth—just ask my guy who coordinates them on our staff! Since 1988 1,450 transactions in the defense industrial base have involved a foreign buyer—or about 90 a year. The number of transactions began trailing downward in 1999 and 2000—with about 75 in each of those years.

In the three years of this Administration, about 150 transactions will have been reviewed at a value of about $15 billion. Eighty were approved; six were withdrawn; one required a divestiture and network security agreement; and the balance were approved with remedies or other agreements to mitigate the Department's concerns.

The Transformation of the Defense Industrial Base

One trend is clear from the recent dollar value of both the CFIUS and HSR transactions: that the market has recognized that "small is beautiful." So have we. In fact, it was to stimulate the entry of what the Secretary of Defense called the "Silicon Valley, thirty-something" entrepreneurs to defense that we published a report this February on transformation of the defense industrial base. In this report, we re-learned the concerns about our enterprise that are actually common to the emerging and the established defense suppliers:

- Insufficient visibility into the military enterprise;
- Inadequate funding and advocacy for new technology transition;
- Difficulty building a strong, interactive relationship with customers;
- Cumbersome system design specifications;

- Length, laborious sales cycles; and
- Limited access to development and investment capital.

Sound familiar? Well, I hope that part of the record of my tenure will be in helping emerging defense suppliers with better bridges into the defense industrial base. And actually, even before the ink was dry on that first major study, we began seeing evidence of companies we had never heard of before making major inroads.

- Take the example of i-Robot. Its first exposure to national security was when its robots helped clear the rubble at Ground Zero. Less than a year later, their robots were hunting the caves in Afghanistan for the Army and Special Operations Forces. This year, they won a spot on the Future Combat System program.
- Or take a look at Foam Matrix: from surfboard manufacturer to UCAV wing manufacturer in less than three years.
- Or Indigo systems—now a supplier to Northrop-Grumman for key radar components on the Joint Strike Fighter!

Poor John Holland whose submarine concepts took decades to sell to the Navy early in the last century!

We believe that since the Joint Staff articulated its functional concepts based on war fighting capabilities earlier this year—and as the Department follows suit by putting the requirements generation and acquisition review process in this new vernacular--the defense enterprise will become even more clear. This will make the entry of emerging suppliers even easier.

My staff is in the process of assessing the capabilities of the defense industrial base using this new war fighting vernacular. We will assess capability of the defense industrial base across the five functional concepts relevant to the industrial base with a report on Battlespace Awareness this January. The other four in the series will follow by early 2005 and cover the other four functional concepts: Command and Control, Force Application, Protection, and Focused Logistics.

The aim of this series is to redefine and reassess within this new architecture which industrial base capabilities are truly critical to the war fighter. It is hoped that the description of defense industrial base capabilities that are truly critical to the war fighter will help to focus our manufacturing base to the challenges of 21st century warfare.

Where we identify deficiencies, we will propose remedies: be they in increased S&T funding, different program management or acquisition strategies, or collaborative measures with other agencies of the government. We have learned that government and industry program management structures and acquisition strategies can provide positive or negative impacts on the number of suppliers, thereby affecting sources of innovation.

For example, government management structures can encourage the development of a sufficient number of suppliers for broad-based innovation in the defense industrial base. On the other hand, if they allow too narrow a focus on Service-specific applications with the prime and its sub-contractors, they can discourage other contractors from contributing competing innovative technologies.

Likewise, industry management structures can positively impact innovation. For example, partnering with competitors for contracts in specific program areas where there are few contract awards and limited funding can produce innovative synergies. In some instances, however, partnering can result in monopolistic behavior that works to exclude competitors and squelch innovation.

Similarly, acquisition strategies can impact innovation positively or negatively. A strategy to fund multiple sources in early technology, for example, nourishes the growth of multiple innovative sources. A strategy that results in contractors having too much responsibility for program development with inadequate government oversight may foster dependence on current suppliers to the exclusion of innovative solutions.

The new 5000-series procurement instructions will help give program managers the necessary flexibility to manage programs so as not to foreclose innovation unintentionally. We also realize that contracting officers will be on the frontlines of implementing our strategies to get the best of what the U.S. industrial base has to offer.

Finally, the Department will also continue to use the interagency processes to influence competition and innovation and to protect national security by using the Hart-Scott-Rodino and Exon-Florio provisions to review mergers and acquisitions. We will work hard to achieve the right balance between export controls that protect national security and those that unnecessarily restrict commercial suppliers. We also will craft cooperative development and testing activities with foreign countries and companies where their technology is critical to our war fighters. In fact, I will have the great honor

of serving on the International Technology Program Advisory Group to actively engage the international high technology community on our behalf.

Conclusion

Future warfighters and new companies will be the ultimate test of our success. Thank you.